

BEFORE THE  
POSTAL RATE COMMISSION  
WASHINGTON, D.C. 20268-0001

Postal Rate and Fee Changes, 2006

Docket No. R2006-1

**NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)  
October 5, 2006**

The Newspaper Association of America hereby provides the answers of witness J. Gregory Sidak (NAA-T-1) to the interrogatories of ADVO, Inc., filed on September 21, 2006. The interrogatories are stated verbatim and are followed by the answer.

Respectfully submitted,

NEWSPAPER ASSOCIATION OF AMERICA

By: William B. Baker

William B. Baker  
WILEY, REIN & FIELDING LLP  
1776 K Street, N.W.  
Washington, DC 20006-2304  
(202) 719-7255

**CERTIFICATE OF SERVICE**

I hereby certify that I have this date served the instant document on all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

October 5, 2006

William B. Baker  
William B. Baker

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

**ADVO/NAA-T1-1.** On pages 9-10 (lines 14 ff) you state:

My understanding of postal ratemaking practice as it has evolved over the years is that the Commission has recognized that economic efficiency is served by accurate pricing signals for each identified worksharing activity (for example, presortation and dropshipping). This recognition enables the work to be done by the lowest-cost provider, whether that is the Postal service, the mailer, or a third-party service vendor to the mailer. To promote such efficiency, the Commission has applied ECP in setting discounts for worksharing such as presortation and destination entry at, ideally, 100 percent of the estimated avoided cost of the activity whose performance the Postal Service avoids. This correct application of ECP advances economic efficiency by providing accurate pricing signals to mailers and the Postal Service. (footnote omitted)

Dropship discounts have been offered in Standard Mail since R90-1 and the cost avoidances supporting those discounts have not been challenged in over ten years. Given this information and your cited comments, do you believe dropshipping discounts should reflect 100 percent of the costs avoided by the Postal Service? Please explain your response.

Answer:

Were one to base dropshipping discounts on efficient component pricing, then yes, those discounts should be set to passthrough 100 percent of accurately measured costs avoided.

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

**ADVO/NAA-T1-2.** On page 10 (lines 3-6), you state: “Under ECP, accurately measured costs avoided would be passed through at a rate of 100 percent to each particular category of mail responsible for those costs avoided. In this manner, each category of mail would be charged only its incremental costs, and the USPS would achieve break-even pricing.”

- (a) Please provide your definition of incremental costs of a particular category of mail.
- (b) Please provide your definition of “category of mail.” In that definition, please explain how the term “category” relates to postal subclasses.
- (c) Please provide your understanding of how “break-even” pricing applies to development of rates within a particular subclass.

Answer:

(a) A review of this concept, the definition for average incremental cost, and the evaluation of incremental cost relative to marginal cost can be found in my article with Professor William J. Baumol.<sup>1</sup> Specifically, average incremental cost for the entire service  $x$  is defined as follows:<sup>2</sup>

$$AIC_x = [TC(x,y,z, \dots) - TC(0,y,z, \dots)]/x$$

In words, this equation states that the average incremental cost to the multiproduct firm for service  $x$  is the total cost to the multiproduct firm including the production of  $x$  less the total cost to the multiproduct firm without the production of  $x$ .

---

<sup>1</sup> William J. Baumol & J. Gregory Sidak, *The Pricing of Inputs Sold to Competitors*, 11 YALE J. ON REG. 171, 176-77 (1994).

<sup>2</sup> *Id.* at 177.

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

This term is then divided by  $x$  to transform total incremental cost into average incremental cost.

(b) In the particular passage cited, I was using “category of mail” to refer to a type of mail within a subclass, such as ECR saturation flats mail. I should note, however, that the particular definition of “category of mail” does not change the basic economic point made in that passage—namely, that accurately measured worksharing discounts passed through at 100 percent are consistent with ECP.

(c) Break-even pricing is a concept that applies to the production of the firm (in this case the Postal Service) across all products that it produces. For that reason, break-even pricing does not directly affect the development of any specific postal rate. Rather, break-even pricing serves as a global constraint that jointly affects the regulated firm. Put differently, firms earn profits, whereas products do not.

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

**ADVO/NAA-T1-3.** On page 10 (line 12-13), you use the terms “opportunity cost,” “access charge,” and “delivery charge.” Please explain how these terms apply to the development of rates for a particular mail category within a postal subclass.

Answer:

Please see pages 8 and 9 of my testimony for a discussion of opportunity cost and its application to postal ratemaking:

“The Private Express Statutes give the Postal Service a legal monopoly over the delivery of the great majority of items in the postal system. In ECP terms, the Postal Service is the sole supplier of the input of “delivery” of a piece of mail. However, the Postal Service faces competition in the processing (presortation, barcoding) and transportation (destination entry) parts of the process. So when the Postal Service “allows” access to its delivery network for such workshared mail, the price of that access (the postage paid) should recover the costs of the delivery network as well as the opportunity cost of the Postal Service’s not providing the workshared activity. In postal ratemaking, this opportunity cost is what the Postal Service would have earned towards the recovery of overhead had it provided the workshared service (and thus the full retail service) instead of the mailer.”

The access charge is the price paid by competitors to access an asset held by the vertically integrated monopolist. Therefore, the access charge is the result of the application of a pricing rule to that monopolist.

As it applies to worksharing, the delivery charge would equal the postal rate for a mail subclass that allowed the Postal Service to recover 100 percent of its attributable costs. The delivery charge plus a portion of the Postal Service’s overhead recovered under a particular rate for a particular subclass of mail would equal the access charge. Put differently, an access charge can be decomposed into two separate pieces, the

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

component that allow the postal service to recover 100 percent of costs attributed and the component that is applied toward the collection of overhead charges.

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

**ADVO/NAA-T1-4.** On pages 11-12 (lines 9ff), you explain why you believe Efficient Component Pricing is generally not applicable to shape-based rates. You state (lines 22ff): “Although the choice of the shape of mail piece might be considered “optional” in some sense, it is not a choice between the mailer or the Postal Service performing a particular function in the type of scenario to which ECP is intended to apply.”

- (a) Please explain what you mean when you say “the choice of the shape of mail piece might be considered ‘optional’ in some sense.
- (b) For a postal subclass serving a specific mail demand/market, please explain how you would develop subclass rates to signal to that market the postal costs of mailing a letter shape vs. a flat shape vs. a parcel shape.
- (c) Please explain how your approach in (b) above would ensure that mailers would be able to minimize the total (postal and mailer) mailing cost consistent with their own demand requirements.
- (d) Please explain how your approach in (b) above would ensure that regardless of the market’s selected mix of shapes, the contribution to USPS institutional cost from that market would not substantively change.

Answer:

(a) Mailers may have a choice of the shape of the mail they ultimately decide to send. For example, for each particular type of advertisement sent there may not be one and only one shape of mail under which it would be profitable to mail that advertisement.

(b) Unless shape were considered a form of worksharing, which I am not aware to be the case, ECP does not apply to shape-based rates. The ratemaker would therefore have to apply other economic and regulatory criteria it is required to apply. As an economist, I would presume that cost differences due to differences in shape would

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

affect differences in rates, as marginal cost is a key factor in determining the price of a good produced by the firm.

(c) By basing price differences on both cost differences and, potentially, on differences in value between the shapes, the price differences would reasonably allow mailers to select the cost minimizing alternative among the set of shape-based substitutes that offer similar value. Put differently, holding the value of the mail shape constant, price difference would be determined largely by the cost difference. Alternatively, holding the shape-based cost differential the same, price differences would be based largely on the difference in value of the mail.

(d) This would be accomplished by setting rates so that the rates of the subclass at least met the desired revenue for that subclass.

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

**ADVO/NAA-T1-5.** Please refer to the Direct Testimony of John C. Panzar (PB-T-1).  
On page 45, lines 9 ff:

More so than in most markets, mailers have the opportunity to “design their own service.” That is, they can choose many of the intrinsic properties of their mailing: its size (one ounce or several); its shape (letter or flat), the time of day at which it enters the mail stream, the location at which it enters the Postal Service network -- and many other of their mail’s characteristics. Two aspects of this flexibility are important for rate-making purposes. First, and most importantly, differences in these characteristics may have important impacts on the costs that the mail imposes on the Postal Service. Second, while mailers may have preferences over these characteristics (e.g., a flat may better serve their purposes than a letter), the relative value of shifting from one alternative to another may be dramatically different than the difference in Postal Service costs. Just as with traditional worksharing, an effective way to induce changes in mailer behavior is through rate differences that reflect cost differences.

The basic economic argument in support of cost-based rate differentials is the same as that for avoided cost worksharing discounts. Mailers can act to minimize end-to-end costs only if the difference in rates for mail with differing characteristics reflects differences in the costs incurred by the Postal Service . . .

- (a) Do you agree with Dr. Panzar? If not, please explain fully why not.
- (b) The current basis for rate differences among ECR Basic, High-Density and Saturation mail (by shape) are their dropship-neutralized mail processing and delivery cost *differences*. Please explain fully whether you believe these differences are strictly worksharing-related and therefore ECP applies to them.
- (c) If you do not believe the mail categories in (b) above to be strictly worksharing-related, please explain how you believe the rate differentials among basic, high-density, and saturation mail should be developed in order to ensure economic efficiency by providing accurate pricing signals to mailers and the Postal Service.

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

Answer:

(a) I agree with the first paragraph in the quoted statement so long as one is considering products with roughly the same economic value to consumers. That is, the main factor that differentiates the products is the cost of producing the product by the firm. In general, however, I stress that ECP was developed to price accurately the access to an input of the vertically integrated monopolist, a concept that seems to me unrelated to differences in mail shape.

(b) Yes. My understanding is that destination entry and presortation are worksharing activities that may be performed not only by the vertically-integrated monopolist (the Postal Service) but also by private firms (mailers).

(c) Not applicable.

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

**ADVO/NAA-T1-6.** On pages 12 and beyond, you discuss several ways to consider and quantify the proposed DAL surcharge. On page 17 (lines 11-13, you state that DALs offer benefits to the mailer not available to high-density mailers that are ineligible to use DALs. In response to VP/USPS-2, the USPS states that for the four-month period of March-June 2006, the following were accompanied by DALs: 7.7% of ECR high-density non-letter DDU pieces, 2.2% of ECR high-density non-letter DSCF pieces, and 2.6% of ECR high density non-letter pieces. This means roughly 4.85% of all ECR high-density non-letters are accompanied by DALs.

- (a) Given that ECR high-density flats also use DALs, do you believe there should be also be a DAL surcharge for high-density flat DALs? Please explain.
- (b) If reliable DAL cost information were available, would you quantify the DAL surcharge on the basis of cost alone? If so and there is a difference in cost between a saturation flat DAL and a high-density flat DAL, should that cost difference be recognized in the two DAL surcharges? Please explain.

Answer:

(a) My understanding is that postal regulations do not permit high-density flats to use DALs. However, to the extent that postal regulations might allow them and the considerations that led the Postal Service to propose a surcharge for saturation DALs would apply as well, then yes.

(b) Please see pages 15-18 of my testimony. Regarding cost differences translating into rate differences, please see my responses to ADVO/NAA-T1-5(a) and ADVO/NAA-T1-4(b). Specifically, to the extent that high-density DALs were allowable, and to the extent that the Postal Service can accurately estimate the separate costs for those DALs and for DALs on ECR saturation flats, then as an economist I would recommend that accurately measured cost differences between those DALs should affect the price differences between them.

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

**ADVO/NAA-T1-7.** On pages 15-16 (lines 15ff), you discuss the possibility of using value-based pricing. On page 17 (lines 14-15) you state that: “. . . another way to view the proposed DAL surcharge is to characterize it as a recapture of revenue displacement.” NAA witness Ingraham, page 2, lines 14-17), notes that ECR high-density and ECR saturation flat rate categories are competitive with each other. In other words, to achieve Total Market Coverage (TMC), one may distribute one’s entire TMC product via the USPS saturation category or one may distribute some of one’s TMC product via the USPS high-density category and the remainder via newspaper private delivery. USPS rates for these two categories can have a large impact on the choice.

- (c) With that in mind, do you believe the USPS should price any of the (substitutable) services offered in the TMC market on the basis of “revenue displacement?”
- (d) With that in mind, do you believe that the USPS should price a portion of one (substitutable) TMC service on the basis of “revenue displacement” but not price the other (substitutable) TMC service in the same way?
- (e) Please confirm that if rates for the various (substitutable) TMC services within the ECR subclass were based on Ramsey pricing or developed to maximize institutional cost contribution, then both value of service and revenue displacement would be implicitly reflected in the results.

Answer:

(a) I believe the Postal Service should and does price the services offered in the total market coverage area in a manner consistent with the concept of the avoidance of “revenue displacement” as it was used in my testimony. For example, were the Postal Service to, hypothetically, eliminate ECR high density as a mail offering, then current ECR high density mailers would have only the ability to use ECR basic or ECR saturation mail. Because certain mailers choose ECR high density at its current rate and because not all mailers would substitute to another form of mail were ECR high density

NEWSPAPER ASSOCIATION OF AMERICA  
WITNESS J. GREGORY SIDAK  
ANSWERS TO INTERROGATORIES OF  
ADVO, INC. (ADVO/NAA-T1-1-7)

not available, the Postal Service would, presumably, be forgoing the recovery of a certain amount of institutional costs by the non-existence of ECR high density.

(b) This section of my testimony discussed the pricing of an optional feature that has value to the mailer, but which the Postal Service no longer finds consistent with long-term efficiency. To the extent that optional feature has any revenue displacement associated with it, another way to characterize value pricing for that feature would be the recapture of revenues displaced—that is, a recouping of revenues that would be gained were this currently unpriced and optional feature eliminated.

(c) To answer this question I assume that “value of service and revenue displacement” is meant to refer to value of service maximization and the minimization of revenue displacement. That said, this assertion is likely incorrect for two reasons. First, “revenue displacement” between two types of mail would be determined by the cross-price elasticity of substitution. The value of the service for a particular type of mail would be determined by several demand factors that are unrelated to the cross-price elasticity of demand (one of those factors would be the own-price elasticity of demand). Second, Ramsey pricing and value of service maximization are generally at odds. The maximization of the value of service is achieved by perfectly competitive pricing, which maximizes consumer surplus.